TECHNICAL DISCUSSION OF TELEPHONE AUDITING PRINCIPLES AND METHODS

Talk by V. P. Russell at Washington Training Conference on Telephone Auditing and Accounting
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We will now discuss some of the problems and situations with which you will be confronted in performing your assignments as telephone examiners, as well as pointing out certain requirements applicable to the examination and the reports to be made.

Borrower's History and Organization

When preparing the report of the preliminary examination of an existing commercial telephone company, the history of the company should be given in the opening paragraph of the examination report, preceding the scope of the audit.

The information to be given would include the following:

1. The organization date of the company, and the state under the laws of which it is organized.

2. Duration of Charter.

3. Authorized capital.

4. Type and par value of capital stock.

5. State whether additional capital has been authorized; if so, type and par value of capital stock.

6. Territory served, and whether rural, urban, or both.

7. Number of exchanges.

This information, or as much as is applicable to the borrower, should be given on newly incorporated companies, and cooperatives.

In the event a cooperative or a commercial company has organized under one charter and later, for some reason, has reorganized under a different charter, the examiner should check to determine whether the original organization has been dissolved. If not, comment should be made in the examination report.

This is not a common occurrence, but we have had that experience. Information concerning a situation such as this may usually be obtained from the minutes of the board of directors' meetings or of the stockholders' meetings.

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When The Accounting for Operations is Based on Fiscal Year Instead of Calendar Year

We have found that some telephone companies operate on a fiscal - instead of a calendar-year basis. Because of calendar-year reporting of corporation income and other tax data, annual reports to regulatory bodies, and operating reports to REA, we recommend strongly that the borrowers make the change to maintain their records on a calendar-year basis. In converting from a fiscal - to a calendar-year basis, it will be necessary for the borrower to communicate with the Bureau of Internal Revenue to obtain approval before any change is made.

When records are maintained on a fiscal basis, any adjustments which apply to yearly accounting must be made to conform to the fiscal year dates.

Refinement of Prescribed Accounts for Class C and D Companies Where Continuing Property Records are to be Maintained

We have recommended during this training course that telephone plant accounts No. 1032 - Station Wiring and No. 1045 - Poles, Conduit, Cable and Wire and Vehicles and Other Work Equipment be subdivided when possible. This recommendation does not necessarily apply only to the FCC prescribed accounts, but it applies also to comparable accounts prescribed by state regulatory bodies, where practicable. This is important where continuing property records are to be maintained.

The alternative to the subdivision of the accounts in the general ledger is a subsidiary ledger in which the desired breakdown of accounts is recorded. It is felt, however, that the subdivision of the accounts in the general ledger is preferable for small telephone companies.

Financial Requirements

The examiner should check with the manager as to whether a bank depository, insured by F.D.I.C, has been selected for the deposit of equity and loan funds and REA notified of this action. If this has not been done, it should be commented on in the Field Activities Report.

All checks for withdrawals of equity or loan funds must be countersigned by an officer of the borrower's organization.

The minute book should be checked to ascertain whether a resolution has been passed delegating authority to sign Financial Requirement and Expenditure Statements. Also ascertain whether a copy of the resolution and Certification of Authority to Sign have been forwarded to REA. If this has not been done, the examiner should explain its importance and give any necessary assistance. Failure on the part of the borrower to take care of this matter should be reported in the Field Activities Report.

The loan contract should be examined for provisions pertinent to any requirements, the fulfillment of which should be verified by the examiner. The loan contract gives full information as to equity requirements.

Cash - General

Many telephone companies, particularily the smaller ones, have a tendency to operate from cash collections. That is, they keep part of the funds collected from subscribers in the office to make change and pay incidental expenses, and some companies even meet their payrolls from cash on hand. This practice should be discouraged. It should be recommended that all collections be deposited in the bank intact; that a petty cash and change fund be established; and that checks be issued to employees for salaries and wages.

Due From Customers and Agents

Excise Taxes

We have found that some of the smaller telephone companies include the respective excise taxes with the credits to exchange revenues and toll revenues in the general ledger, or such records as are maintained. Later, when payment is made to the Collector of Internal Revenue, the respective revenue accounts are debited with the amount of such payment.

(Excise tax - local service revenue - 15%.)
(Excise tax - toll revenues - over 24¢ - 25%.)

This method of accounting for the excise taxes results in an overstatement of revenue and an understatement of liabilities. Setting up the proper accrual method of accounting will automatically correct this situation, but before setting up the accruals, it will be necessary for the examiner to determine how the company has been paying the excise taxes, that is, whether on the basis of billings or collections. If on the basis of collections, it will be necessary for the examiner to thoroughly analyze the outstanding accounts due from subscribers to determine the unpaid excise tax on local and toll service revenues in order that the unpaid taxes may be recorded on the books as a liability. The entry to make this correction would be a debit to the revenue accounts and a credit to accounts payable.

In accordance with a ruling of the Bureau of Internal Revenue it is permissible for telephone companies to pay excise taxes on the basis of collections from the subscribers, and where the company maintains adequate control over this method of reporting and paying taxes we do not suggest making a change. However, where the company does not maintain adequate control, we recommend that the method of reporting and paying excise on billings be adopted. When this method is followed, it is necessary to make adjustments in the amount due the Collector of Internal Revenue when subscribers' accounts are charged off as uncollectible.

Discounts - Subscribers Accounts

The rate structure of some companies is set up to provide for a discount to be allowed the subscribers if bills are paid on or before a certain date.

The excise tax on local service charges, where a discount is part of the rate structure, is usually computed on the net bill; therefore, where bills are not paid within the discount period, the tax on the discount must be computed and recorded on the subscribers' ledger and in the general ledger.

Adjustments

It has been found that many commercial telephone companies, when making adjustments of subscribers' accounts, enter the adjustments directly to the subscribers' ledger without writing up an adjustment voucher. At the close of the accounting period, the amount to be debited or credited to the Due From Customers and Agents account in the general ledger as the net adjustment is obtained by an analysis of the adjustment column in the subscribers' ledger. While this method results in the same entries being made in both records, it does not provide a control to prevent failure to record proper entries for adjustments in the subscribers' ledger, nor does it provide a means for the manager or other responsible person to determine and approve the propriety of the adjustment. The use of an adjustment voucher should be recommended and encouraged, and, if necessary, assistance given in adopting it to the company's use.

Unbilled Toll

It is common practice for telephone companies to bill the subscribers for local service in advance and toll service in arrears. Therefore, at the close of any accounting period, the company has earned revenue for toll services which has not been entered on the books through the normal channels for that period. This earned but unrecorded revenue may be entered on the books of the company at the close of the accounting period by debiting Due From Customers and Agents - Unbilled Toll for the unbilled revenue and crediting toll revenue for the toll charges and accounts payable for the excise tax. At the same time, it will be necessary to record the amount due the connecting company for its share of the unbilled tolls (estimated if not known) by debiting toll revenues and crediting Accounts Payable. This may be done monthly by the bookkeeper, and an entry made to reverse at the beginning of the following month. Under any circumstances, unbilled toll should be taken into consideration at the close of the year.

Material and Supplies

Very few of the smaller telephone companies maintain adequate material records. The material and supplies purchases made by such companies are usually small, and often purchases are made for specific purposes.

The procedure usually followed by the smaller companies is to charge material and supplies purchased for specific pur oses to the appropriate plant or expense account when payment is made. The general purchases of material and supplies are charged to the Material and Supplies account when payment is made. At the close of the accounting year, a physical inventory is taken of the material and supplies on hand and the plant and expense accounts are adjusted to absorb the difference between the book value and the physical inventory value.

This, of course, is not good accounting practice. The company personnel should be advised and encouraged to keep an accurate record on daily work reports of the material used, and the charges for the material should be distributed monthly to the appropriate plant or expense accounts.

We realize that many of the companies are operating with a minimum number of personnel, and that the installation of many of the procedures ordinarily considered as being essential to larger companies would require the employment of additional personnel which would inflict a greater financial burden on the company than the net results would justify. However, reporting the material used daily on the daily work report would necessitate very little additional time and effort and the results would be amply justified. It is impossible to properly maintain plant values of record unless materials used are charged out as used. The accuracy of the plant and expense accounts are dependent on the reports from the field.

It is through the failure to properly allocate material costs, and to properly distribute payroll and overhead costs that so many telephone companies cannot present exhibits to properly reflect plant values to justify a rate increase. It may even be necessary for the company, because of improperly maintained records, to employ an engineer to appraise its telephone facilities, in order to obtain a much needed rate increase. This, at best, is usually a costly procedure.

Material Salvage

It is just as important for the borrower to record the return of salvaged material to stock as it is to record the material used. This information also should be recorded on the daily work reports.

Re-usable material should be recorded on the books of the company at current average cost.

Prepayments - Insurance

In the examination of borrowers' records, we have found that generally premiums on all insurance policies, regardless of whether the expense is applicable to other than the current year, are charged in total to insurance expense. This, of course, necessitates an adjustment in order that the portion of the premium applicable to a subsequent period may be recorded as a prepayment.

The examiner should ascertain whether the borrower has received a letter from REA outlining the insurance requirements. If a letter has been received by the borrower from REA, the insurance policies should be examined for compliance. If there is any deviation from the requirements stated in the letter, this should be commented on in the examination report and Field Activities Report. If all of the insurance requirements have been complied with, a statement to that effect should be made in the examination report.

Capital Stock

When examining the records of commercial companies having authorized capital stock, examine the Articles of Incorporation, charter, and minute book for pertinent information concerning the corporation, as follows:

- Authorized capital.
- Type of stock to be issued.
- Par value.
- Voting rights - common.
- Whether preferred stockholders have voting rights under certain conditions.
- Whether preferred stock is cumulative or non-cumulative.
- Whether additional capital has been authorized; if so, type and par value of capital stock.

This information should be included in the examination report.

The capital stock account in the general ledger should be reconciled with the stock shown as outstanding by the stubs in the capital stock certificate books and the capital stock record book.

Check information on reissued stock to make certain that the certificates which have been reissued have been properly endorsed, cancelled and pasted on, or attached to, the respective stubs.

Check to see that federal documentary stamps have been attached to stubs for all stock issued since the date documentary stamps were first required. If stamps have not been attached, inform the manager, for the company's protection, that this is a requirement.

Any differences between the stock certificates shown as outstanding by the stubs and the general ledger account, and the nature of the differences, should be reported on the examination work paper and in the examination report.

When examining the minute book of commercial companies, check for resolutions as to the declaration of dividends — both preferred and common, if both types of stock have been authorized and issued. Follow through by an examination of the accounting records to determine whether all dividends declared have been paid.

Dividends declared may not be recorded on the books as either Dividends Accrued or Matured Dividends, prior to the examination date (if unpaid). In this event, an adjustment entry should be made by the examiner for recording on the books. This should be commented on in the examination report.

Further, when cumulative preferred stock has been issued and dividends have not recently been declared, the examiner should determine the date when dividends were last declared and paid. This information should be given in the examination report.

In the event dividends have been declared and are unpaid they should be recorded on the books. If cumulative preferred stock has been issued on which dividends have not been declared at a dividend period, such information should be contained in the Liability Certificate to be signed by the Manager. Undeclared dividends on cumulative preferred stock also should be footnoted on the balance sheet.

Funded Debt

When an existing commercial company, having an outstanding funded debt, enters into negotiations with REA to borrow funds to improve its facilities, arrangements must be made to liquidate the funded debt.

The liquidation of the funded debt is, of course, dependent on whether the terms of the instrument securing the debt provide for liquidation before mauturity date. That is, if a mortgage, may the mortgage be paid off at any interest date; if bonds, are the bonds callable? Also, what penalty, if any?

It is the responsibility of the Office of The Solicitor to investigate all of the legal aspects as to the liquidation of the debt before final negotiations are entered into by REA with the borrower. After release of loan funds to the borrower is authorized, in accordance with a condition of the loan contract where refinancing of outstanding indebtedness is involved, the first advance of funds to the borrower shall be for the purpose of liquidating the obligation. No subsequent advance shall be made until the borrower has submitted to REA evidence of the liquidation of the outstanding indebtedness.

When making the preliminary examination of the borrower's records prior to the first advance of funds, the examiner should obtain all available information relative to the funded debt. Usually the company will have correspondence concerning the matter in its files. Ask to see the correspondence. Note the terms, such as premium or penalty to be paid, the date set for the funds to be in the trustee's hands, the date set for the liquidation, and any other pertinent information. If the funded debt is represented by bonds, request the company's copy of the bond indenture and ascertain whether the indenture specifically states that the bonds are callable. All available information should be given in the examination work papers, including a statement as to

the extent of the examination of the various papers and instruments relative to the debt. This information should also be included in the Field Activities Report.

Notes Payable

When reporting on notes payable in the examination report, especially in the event the note (or notes) has been executed subsequent to the preparation of the pro-forma balance sheet, the purpose for which the funds were borrowed should be stated. This should also be commented on in the Field Activities Report.

Accounts Payable

When the outstanding accounts payable are excessive -- that is, beyond the normal operating activities of the company -- the purpose for which the purchases were made should be determined and the information included in the examination report, and in the Field Activities Report.

Depreciation

It has been our experience that most of the small telephone companies apply a composite depreciation rate to the total telephone plant including buildings, furniture and fixtures, and vehicles and other work equipment. On this basis the latter items, due to the variation of service life, become fully depreciated, although depreciation rates continue to be applied after the service life has expired.

Some of the State regulatory bodies, where jurisdiction is exercised, and the FCC, generally require for Class A and B telephone companies that the reserve be broken down by classes of plant. For Class C and D telephone companies, it is generally optional as far as the regulatory bodies are concerned. However, where records are adequately maintained, we recommend that the depreciation reserve account be broken down and subaccounts maintained for the reserve relative to Account 1012 - Buildings, 1061 - Furniture and Office Equipment, 1064.1- Vehicles, and 1064.2 - Tools and Other Work Equipment. We also recommended that subsidiary records be installed.

Where a borrower plans to rehabilitate its existing plant, or construct entirely new lines and plant, by force account, it is essential that the depreciation on vehicles and heavy work equipment be so maintained that such costs may be properly allocated to the cost of construction.

The examiner should ascertain the rates being used by the company and analyze the Depreciation Reserve account to determine whether depreciation has been properly computed, and whether debits and credits to the account are appropriate.

The Surplus account should be analyzed, if records are available, in order to determine whether the balance in the account represents actual earned surplus.

If amounts entered in this account are not relative to earned surplus the work papers should indicate their source, and, if considered of sufficient importance, comment should be made in the Field Activities Report.

Engineers' Appraisal of Remaining Existing Operating Telephone Plant at Completion of New Construction

Of the existing commercial companies to whom REA is making loans, (as well as cooperatives acquiring existing facilities as the nucleus of the organization,) some will retain a portion their existing facilities but generally the existing facilities will be entirely dismantled.

There will be incorporated in the engineering contract a clause providing for an appraisal, where applicable, by the company's engineer of all existing facilities remaining in operation after the completion of the new construction. The appraisal by the engineer will provide the following:

(1) A basis for recording the remaining existing telephone plant on the books of the borrower at original cost (estimated, if not known);

(2) A basis for setting up the depreciation reserve to cover the expired service value of the remaining existing telephone plant; and

(3) A basis for the unit costs of the remaining existing telephone plant to be incorporated in the continuing property records.

Even in the event the borrower's records have been properly maintained throughout -- that is, the plant values are correctly stated, depreciation accounting has been maintained, continuing property records are complete and accurate, and retirements, with applicable removal costs, have been recorded as they occurred -- it will be necessary that the engineer appraise the existing operating telephone plant to determine its percent of existing service life. This is necessary in view of the difficulty of properly allocating the book reserve applicable to remaining existing operating plant.

Accounting Treatment for Retired Telephone Facilities

Due to the fact that generally the values of telephone plant reflected on the books of REA telephone borrowers are misstated and in some cases no depreciation accounting is maintained, it is necessary to apply other than the normal accounting treatment.

In accounting for the retirement of telephone plant under these conditions, certain factors in the borrowers' prior accounting methods must be taken into consideration. It may be found that some companies have not established depreciation accounting in their records; others may have established depreciation accounting but have not been consistent in maintaining it; and some may have adequate records. In each case the accounting treatment, while following a general pattern, will vary to a certain extent. The following examples take into consideration the various situations which may exist:

Case 1

In the event depreciation accounting has not been established and maintained on the borrower's records and none of the existing plant remains in place, the following method will be used in accounting for retirement of plant.

(1) Transfer to Account No. 1200 - Plant Adjustments - the balances in the applicable accounts representing the existing plant.

(2) Credit to Account No. 1200 - Plant Adjustments - the usable material salvaged from the retired plant (at current average costs).

(3) Debit to Account No. 1200 - Plant Adjustments - the labor and applicable overhead for cost of removal of the existing telephone plant.

If the net balance in Account 1200, after the above entries have been made, is small, the borrower may elect to debit the Surplus account with the entire amount.

If the net balance in Account 1200 is substantial and the borrower does not wish to debit the Surplus account with the entire amount, it may be allowed to remain in the account and amortized over a period of years, subject to approval by the State regulatory body.

Case 2

In the event depreciation accounting has not been established and maintained on the borrower's records and a portion of the existing plant remains in place, the following method will be used in accounting for the retirement of plant:

(1) Transfer to Account No. 1200 - Plant Adjustments - the balances in the applicable accounts representing the existing plant.

(2) Credit to Account No. 1200 - Plant Adjustments - the usable material salvaged from the retired plant (at current average costs).

(3) Debit to Account No. 1200 - Plant Adjustments - the labor and applicable overhead for cost of removal of the existing telephone plant.

(4) From the engineer's appraisal inventory of original cost (estimated, if not known) prepare entry to transfer from Account 1200 - Plant Adjustment to the appropriate telephone plant accounts the value, at original cost, of the existing operating telephone plant remaining in place.

Note: The applicable portion of the engineer's fee, when appraisal is made, is also charged to Account 1200 - Plant Adjustments.

In making the appraisal, the engineer shows the percent of telephone plant depreciated. This percent depreciated relative to the remaining plant is set up as a credit to the Depreciation Reserve account and a debit to Account 1200 - Plant Adjustments.

Instructions with respect to the disposition of the net balance in Account No. 1200 - Plant Adjustments - are the same as in Case 1.

Case 3

In the event depreciation accounting has been established and maintained on the borrower's records and none of the existing plant remains in place, the following method will be used in accounting for the retirement of plant:

(1) Transfer to Account No. 1200 - Plant Adjustments - the balances in the applicable accounts representing the existing plant.

(2) Credit to Account No. 1200 - Plant Adjustments - the usable material salvaged from the retired plant (at current average costs).

(3) Debit to Account No. 1200 - Plant Adjustments - the labor and applicable overhead for cost of removal of the existing telephone plant.

(4) Transfer to Account No. 1200 - Plant Adjustments - the balance in the Depreciation Reserve account.

Instructions with respect to the disposition of the net balance in Account 1200 - Plant Adjustments - are the same as in Case 1.

Case 4

In the event depreciation accounting has been established and maintained on the borrower's records and a portion of the existing operating plant remains in place the following method will be used in accounting for the retirement of plant:

(1) Transfer to Account 1200 - Plant Adjustments - the balances in the applicable accounts representing the existing plant.

(2) Credit to Account No. 1200 - Plant Adjustments - the usable material salvaged from the retired plant (at current average costs).

(3) Debit to Account No. 1200 - Plant Adjustments - the labor and applicable overhead for cost of removal of the existing telephone plant.

(4) Transfer to Account No. 1200 - Plant Adjustments - the balance in the Depreciation Reserve account.

(5) From the engineer's appraisal inventory or original cost (estimated, if not known) prepare entry to transfer from Account 1200 - Plant Adjustments - to the appropriate telephone plant accounts the value, at original cost, of the existing operating telephone plant remaining in place.

Note: The applicable portion of the engineer's fee, when appraisal is made, is also charged to Account 1200 - Plant Adjustments.

In making the appraisal, the engineer shows the percent of telephone plant depreciated. This percent depreciated relative to the remaining plant is set up as a credit to the Depreciation Reserve account and a debit to Account 1200 - Plant Adjustments.

Instructions with respect to the disposition of the net balance in Account No. 1200 - Plant Adjustments - are the same as in Case 1.

Where the Depreciation Reserve account has not been subdivided to indicate the applicable reserve for Buildings, Furniture and Office Equipment, Vehicles, and Tools and Other Work Equipment, such depreciation reserves must be taken into consideration before transferring the balance in the Depreciation Reserve account to Account 1200 - Plant Adjustments.

Note: In the accounting treatment for retirement of existing plant as given above, only Class C and D accounts have been considered. In Class A and B accounting, the account number and title comparable to Account No. 1200 - Plant Adjustments is Account No. 100.7 - Telephone Plant Adjustments.

Maintaining Accounting for Telephone Companies by Exchanges

It is not necessary to maintain the accounting for telephone companies by exchanges, but it is desirable. This is true in cases where it is necessary for telephone companies to render tax reports by taxing areas, and where exchange rates vary. It is also advantageous in maintaining Continuing Property Records, and in the event of a sale of a single exchange.

Accounting on an exchange basis is accomplished by subdividing plant costs, related depreciation reserve, revenue, and expense accounts. This method of accounting is also helpful from the managerial standpoint, as it enables management to analyze the operating activities of the separate exchanges.

Comments

Throughout this entire training course, we have concentrated on the accounting for Class C companies and the problems encountered in the examination of the smaller companies. However, we feel certain you will be able to apply the information given you to the accounting for Class A and B companies with little difficulty.